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A Picture of Bankruptcy: Through the Lens of Kodak

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A Picture of Bankruptcy: Through the Lens of Kodak

Abstract

Bankruptcy is one of the most complex areas of the law. It is this complexity that leads to a lack of common knowledge regarding what bankruptcy is, how it works, and why it is used. This paper provides an overview of the complex steps involved in filing a petition for Chapter 11 bankruptcy. A case study is used to illustrate the process. In 2011, Kodak, an iconic brand that is recognized in nearly every country around the world, filed for bankruptcy. The paper provides a brief history of the company and its many innovations as well as a description of the company's efforts to reduce liabilities, restructure and regain profitability.

Faculty mentor: G.T. Williams

When debts exceed assets, bankruptcy can offer a solution. Although it often has a negative connotation attached to it, most agree some type of relief should be available. The relation of debt and relief of dates back to 1,600 BCE; and because debt exists and always will, laws were created to help those in need. The U.S. Supreme Court agreed and expressed its purpose in their 1934 decision, stating, “[It] gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt” (Parsons, 2011). If only it were as simple as the U.S. Supreme Court stated.

Bankruptcy is one of the most complex areas of the law. It is this complexity that leads to a lack of common knowledge in relation to what it is, how it works, and why it is used. A new opportunity, a fresh start, a clean slate; those are the impressions most common relative to bankruptcy. This paper will illustrate that it is much more than that.

Bankruptcy is a proceeding, a legal action commenced by the filing of a petition. It can be done voluntarily by the debtor or involuntary by the creditor and formally opens a bankruptcy case. There are many individuals and steps involved in this procedure; though it begins with the debtor, the one who owes money, and the creditor to whom the debt is owed. Because federal courts have exclusive jurisdiction over the cases, the petition cannot be filed in a state court, but rather a bankruptcy court. The process is governed by the Bankruptcy Code (title 11 of the U.S. Code, hereinafter “The Code”), the procedures outlined by the Federal Rules of Bankruptcy Procedure, with application of the debtor’s local court rules (Parsons, 2011). There are six types of bankruptcy, referred to as chapters. The chapters are referred to by numbers and define differences as to qualifications the debtor must meet, and most importantly how the debt

is handled upon the case being discharged (U.S. Courts, n.d.). Applicable to this paper is Chapter 11, one of the most complicated. It is reviewed through the following summation.

A Chapter 11 bankruptcy, defined by The Code, is a reorganization plan, commonly involving a corporation or partnership (U.S. Courts, n.d.). Essentially it provides businesses with large volumes of debt an alternative to insolvency. It is not uncommon though for some liquidation to occur under this chapter. Most businesses will need to shed portions of the company that were not producing a profit, hence the reason they are in this circumstance. The purpose of Chapter 11 is to allow the entity time to reorganize its financial affairs. In order to qualify from a financial standpoint, unsecured debt must exceed \$360,475 and secured debt must be in excess of \$1,081,400. These figures are current as of April 10th, 2010 and are subject to adjustment every third year (Parsons, 2011). Typically though, the debt is in the millions and the ultimate goal is to keep the company alive, emerge and become profitable again. Once qualifications are met, the filing of a Chapter 11 case can begin. The thirteen stages involved support why this chapter can take three to five years to complete and explains the crucial role of the creditor.

The filing of a petition in a U.S. Bankruptcy Court officially commences the case. Additional documents which must be filed with the petition, or within the 14 days following, are significant. They include schedules of the debtor's assets and liabilities, a statement of corporate ownership, the company's financial affairs and a list of the equity security holders. The company is now referred to as a debtor in possession (DIP). It retains control of its assets and allows for the business to continue operating, under close supervision of the U.S. Trustee. This is to ensure the plan of reorganization remains an effective one (Parsons, 2011).

The petition triggers an automatic stay that impedes creditors from any further collection of debt and property in which the debtor holds a legal or equitable interest, an obvious advantage to the debtor, though a disadvantage to the creditor. The automatic stay leads directly into the next two stages, as there are grounds in which the creditor can request that it be lifted (Parsons, 2011)

The next two stages are crucial; they juxtapose and attest to the complexity of this area of the law, specifically in relation to a Chapter 11 case. A creditors' committee is appointed to represent the interest of the creditors since they are now prohibited from having any contact with the debtor. They usually consist of the seven largest unsecured creditors and are represented by their own counsel (Parsons, 2011). Next, are preliminary operational motions where the legal counsel representing the debtor will solicit court approval as to how it is going to use or dispose of its assets so that it can start becoming profitable (Parsons, 2011). These include, but are not limited to the use of cash collateral, the use or sale of property, payment of the debt, and hiring of professionals. It is these two stages within this proceeding that can determine who or what is going to get disposed of. In rare cases, a motion is approved that allows the DIP to incur secured postpetition debt through extended credit or loans (Parsons, 2011). This assists the company in paying employees, vendors, suppliers, and administrative fees that are essential to survival during the proceeding. This lender is now has a superpriority claim. It is for this reason that creditors play such a central role in the proceedings.

Subsequently, the plan negotiation period begins, which involves motions regarding financing, contracts and interim compensation. The debtor now has the benefit of a 120-day period to file a plan that details the repayment the debt, and provides a schedule that lists those to whom the debt is owed. The fourth stage involves a hearing to approve a disclosure statement

that is released to those listed, to allow them to evaluate the proposal. If a creditor was not listed on the debtor's schedule, they must file a proof of claim and even then the DIP can object (Parsons, 2011). On the contrary, equity security holders, the holders of an ownership interest in the company (e.g., stockholders who own shares in the company), do not need to file a proof of interest. Their rights are established in the disclosure statement itself (SEC, n.d.).

Following the plan negotiation is the solicitation of support and a vote takes place on the plan. A confirmation hearing is held and any objections to the plan are heard. An order of confirmation is entered if the plan is accepted, or by cramdown over objections. The discharge of preconfirmation debts occurs upon approval, and the debtor operates pursuant to the authorized plan. The case is then finally discharged, and the debtor emerges as a now profitable entity. If the debtor is unable to complete the plan, it must liquidate any remaining nonexempt assets. The remaining money is then distributed amongst the creditors; the business ceases operation and no longer exists as a company. This proceeding, as seen through the 13 stages, can take up to 3-5 years to complete (U.S. Courts, n.d.).

Throughout these stages, creditors and claims are mentioned often and there is a priority structure in regards to how, when, or if, their debts are satisfied. Secured creditors are those who hold a claim against the debtor with security interest or collateral, such as suppliers of products or employees of the company. A claim is defined under The Code as the creditor's assertion of a right to payment from a debtor or the debtor's property. Priority refers to the order in which the unsecured claims are to be paid. The priority order in bankruptcy is also defined under The Code and dictates the order in which claims are paid with decreasing order of priority. Each priority level must be paid in full before the next lowest priority level may receive payment (U.S. Courts, n.d.).

Unsecured claims are when a creditor holds no special assurance of payment; a debt for which credit was extended based solely upon the creditor's assessment of the debtor's future ability to pay (U.S. Courts, n.d.). Multi-billion dollar businesses frequently have a large number of unsecured creditors simply because of their worth at the time the credit was extended. That encompasses a huge risk when filing under this chapter, due to the priority order as secured creditors will be paid before unsecured creditors. Superpriority, although rare in most cases is priority granted to the holders of claims that is superior even to other priority claims (Parsons, 2011). An example, mentioned earlier, is when the debtor is approved for a postpetition loan.

Administrative expenses rank in priority above all and for apparent reason. These expenses are required to initiate the filing, and are further incurred while the proceeding takes place. Also included as priority are employee wages, with monetary and time limitations. They are limited to \$10,950 per worker for the 180 day period prior to the business filing their petition (U.S. Courts, n.d.). While that sounds like a nominal amount, recognize that most of the companies filing under this chapter have thousands of employees; so that figure rises quickly considering the numbers.

There are some debts that are not subject to discharge, e.g., certain types of tax claims, debts not set forth by the debtor on the lists and schedules, and debts owed to certain tax-advantaged retirement plans (U.S. Courts, n.d.). And again, most large companies have retirement plans, and that sum can add up quickly depending on many things. Now that we have reviewed the process of a Chapter 11 bankruptcy, we can see how it applies in a real-world situation.

As society has seen throughout the years, and more recently with the unstable economy, many businesses are seeking relief through Chapter 11. A few of the largest and most

recognizable brands that have filed under this chapter since 2002 include Blockbuster, General Motors, Delta Airlines, Borders and K-Mart (Schutte, 2011). In 2011, Kodak, an iconic brand that has been recognized in nearly every country around the world for over 100 years joined the list (2012).

Eastman Kodak Company was founded and coined Kodak by George Eastman (Kodak, n.d.). His love of photography and obsession for simplifying it changed the world. As Eastman described, the amount of products involved "was a pack-horse load," and the processing of the film was not an easy task; so he decided to make it one. Through his evaluations of British photography publications he took notice of a particular formula they used in wet plate processing and sought to make it better. In 1880 he invented a dry plate formula, patented a machine for making the plates and set up a business in Rochester, New York to sell them to photographers. "The idea gradually dawned on me," Eastman later said, "that what we were doing was not merely making dry plates, but that we were starting out to make photography an everyday affair." In 1888, Eastman presented the world to its first, easy-to-use camera (Kodak, n.d.). Kodak's slogan, "you press the button, we do the rest," introduced consumers to an entirely new way in which to view photography ("The Economist", 2012).

Throughout the years, Kodak celebrated many remarkable milestones. Perhaps the most noteworthy came just a year later in 1889 when Eastman marketed the first commercial roll film. Because of this, Thomas Edison was able to invent the motion picture camera in 1891. This collaboration led the company to a fascination with film, from the ease of processing without a darkroom, to helping motion pictures make color a possibility (Kodak, n.d.). By 1962, the company's U.S. consolidated sales surpassed \$1B and employment, now worldwide, exceeded 75,000 (Kodak, n.d.). A Kodak camera was used on the Apollo 11 mission in 1969 and NASA

said that a Kodak camera was used by the astronauts to film lunar soil from only inches away (Carews, 2012). In 1976, Steven Sasson, an electrical engineer at Kodak, invented the first digital camera (“The Economist”, 2012). However, Kodak did little to pursue the market at that time.

By 1976, Kodak owned 90 percent of the film market and 85 percent of the camera market in the United States. Kodak turned down the chance to sponsor the 1984 Olympics and Fujifilm jumped at the opportunity. As a result, they gained a 17% share in the U.S. photography market (“The Economist”, 2012). Their increase in U.S. marketing, lower prices and recognition for the need to diversify successfully put them at an advantage; and other companies soon followed.

Even with increased competition, Kodak celebrated many more landmarks. Their revolutionary concepts produced countless products and achievements that continued to advance the brand’s recognition. Wi-Fi connections, touch-screens, and docking stations used to transfer photos to computers are all credited to Kodak (Carews, 2012). Instead of capitalizing on these ideas; Kodak increased production of their digital cameras at lower cost, while spending money making film to sell to consumers at an expensive one. Rosabeth Moss Kanter of Harvard Business School, who has advised the firm, said its executives “suffered from a mentality of perfect products, rather than the high-tech mindset of make it, launch it, fix it.” She elaborated by commenting on the many years it took Kodak to make its first acquisition, once it realized the significance of digital technology (“The Economist”, 2012). Although sales eventually ranked Kodak number two in the digital camera market by 2001, they were losing \$60 on every camera sold (Kurtz, 2012).

Antonio M. Perez, formerly with Hewlett-Packard, joined Kodak in 2003 and despite criticism, was named CEO in 2005. He made many attempts to reinvent the company by focusing on printers, packaging and work force software. Those attempts came at a cost of \$2 billion. "The printer initiative took over (in the last decade), and they took their eye off the ball in the camera and camcorder space," IDC analyst Christopher Chute stated (Carews, 2012). Kodak's decision not to pursue their invention of the digital camera and take advantage of their own contributions to technology was a costly decision, not only in the area of profit and competition, but to the detriment of the company itself.

On January 11, 2011, Eastman Kodak Company filed their petition in the U.S. Bankruptcy Court, Southern District of New York (2012). The company is being guided through this process by chief restructuring officer, James Mesterharm, a managing director at the consulting firm, AlixPartners. Kodak's counsel is the law firm Sullivan & Cromwell, LLP, located in New York, New York (De La Mercedb, 2012). In the court filing, Kodak's chief financial officer, Antoinette P. McCorvey said, "Since 2008, despite Kodak's best efforts, restructuring costs and recessionary forces have continued to negatively impact the company's liquidity position." (De La Mercedb, 2012)

At this point, Kodak far exceeded the amount required to qualify under Chapter 11. Their liabilities were listed at \$7.7B, with assets of only \$5.1B and they owed over 100,000 creditors (2012). The automatic stay is advantageous in this case considering the enormous number of creditors involved. With that realization, it did not take long for Kodak's creditors to form a committee and hire counsel to represent them. Some of the best known entertainment companies listed as unsecured creditors include Sony, Paramount, Warner Bros, Disney and Nokia (Staff, 2012). These five companies alone make up \$30M of Kodak's unsecured debt.

A Chapter 11 restructuring plan allows Kodak to modify the rights of secured creditors; this is more commonly known as cramdown, which gives Kodak the right to confirm their plan of reorganization (Parsons, 2011). This reduces some of Kodak's liabilities, which can support them in becoming profitable again. The plan must be accepted by the creditors, bondholders, and stockholders, and confirmed by the court. However, even if creditors or stockholders vote to reject the plan, the court can disregard the vote and still confirm the plan if it finds the plan treats creditors and stockholders fairly (SEC, n.d.). Allan L. Gropper, the federal bankruptcy judge overseeing the case said, "Kodak is a great American institution, and every creditor here, I'm sure, wants to see it get out of Chapter 11 as soon as possible and to prosper. The question today is how to do that quickly and simply" (De La Merceda, 2012).

In February of 2012, Kodak was approved for the often rare postpetition DIP loan. Citigroup Inc. extended a \$950 million, 18-month loan that is funding their ability to attempt to maintain the entity (De La Merceda, 2012). Why would a financial institution extend such a loan to a company in bankruptcy proceedings with debt in the billions? The reason relates back to the priority scheme in a Chapter 11 Bankruptcy. Citigroup now has a superpriority claim; they will be the first and possibly the only creditor to be paid depending on the outcome of this case. This superpriority leaves creditors concerned and with good cause; their odds of recovering any money due to them are minimal. The attorney representing Kodak's creditors, Michael Satmer agreed, stating "From our perspective, what's past is prologue; they have taken what we believe is reckless and destructive spending and imposed them on this case" (De La Merceda, 2012). By the end of April, Kodak had received 1,100 proofs of claims totaling \$181M.

Kodak's largest groups of unsecured creditors are bondholders (Staff, 2012). Because a corporation exists separate and apart from its owners, the personal assets of the stockholders are

not at risk other than the value of their investment in the company's stock. However, in most cases, and as projected by in the case of Kodak, shareholders will be left with stocks that are worthless or near worthless (SEC, n.d.). This is because their statutory ranking falls low on the Bankruptcy Code's priority scheme. During the restructuring process, bondholders will stop receiving interest and principal payments, and stockholders will stop receiving dividends (SEC, n.d.).

In a meager attempt to further reduce liabilities and what one might view as a last attempt to avoid full liquidation; Kodak filed a motion in March to cease Medicare enhancement benefits for those who retired after Oct. 1, 1991. What Perez stated as "legacy costs" are supplemental health care and survivor benefits for Medicare eligible retirees (Carews, 2012). The Eastman Kodak Retirees Association, known as EKRA, fought to protect these worthy individuals and opposed the plan, asking the court to deny the request. EKRA President Bob Volpe (Hayes, 2012) said his organization is "extremely pleased" with the decision that the court delayed its approval. Elaborating, Volpe continues "The judgment by the court keeps open the possible choices for a broader, all-encompassing negotiated solution to reductions in retiree benefits; this decision also reinforces the value of the three years of work invested by over 50 EKRA volunteers to build a relevant organization." Kodak withdrew this motion in April (CBS, 2012), stating that, "Once the ... committee is formed, we will take another look at what is the best approach to address our legacy retiree costs".

One month following their motion to cease retirement benefits and just days after withdrawing it, Kodak sought permission from the court to use cash from their DIP loan to pay approximately 300 executives and other employees a total of \$13.5 million in bonuses to motivate them to stay with the company during this reorganization process (Aster, 2012). Tracy

Hope Davis, the U.S. Trustee overseeing the proceedings, said, “The debtors must meet a heavy burden to show that these employees are not insiders as that term is defined in the Bankruptcy Code,” and continued with “Unless and until the debtors meet their burden, the bonus plan must be denied (Aster, 2012).

Kodak’s goal to emerge a profitable company again, post-bankruptcy proceedings, involves a focus on the inkjet printer market, CEO, Perez stated. Asserting his belief, Perez continues, “We will now be well-positioned to complete our transformation,” He supports that belief by elaborating, “Competing in large markets, where we have fundamental technology advantages, such as in digital printing, in packaging, in functional printing, in materials” (Carews, 2012). This statement sounds vaguely familiar to his initial goals when he was named CEO of Kodak in 2005.

Kodak, a company that invented the first digital camera, failed to keep up with the growth of technology. Lack of diversification, poor management decisions and diminishing profits ultimately led Kodak to file a Chapter 11 bankruptcy. Reducing liabilities will save them money. Betting on profits in a market that failed under the same CEO in the years preceding may cost Kodak even more; their 132 year-old iconic brand. Their decisions during this pivotal time of restructuring through Chapter 11 bankruptcy will determine whether they become a picture of the past, or a portrait of the future. Supported by the repetition of poor management decisions both prior to and during their bankruptcy, I am holding on to pictures of the past; taken of course with my Kodak camera.

A SNAPSHOT OF KODAK'S DEBT*

Note: Unaudited, Numbers (in millions) are current as of March 31, 2012		
ASSETS		
	Cash and cash equivalents	\$1,361
	Receivables	\$968
	Real Estate	\$844
	Plant property and equipment	
	Inventory	\$676
	Finished goods, work in progress, raw materials	
	Deffered income taxes	\$66
	Other	\$860
	Goodwill	\$278
	Value of established business; e.g., the brand of Kodak	
TOTAL		\$ 5,053
LIABILITIES		
	Secured Creditors/Notes/Claims	
	Citibank (DIP Loan)	\$950
	Financing of	\$36
	Foreign term notes	\$80
	Professional fees	\$52
	Banks and leasing companies	\$24
	Banks and 3rd parties for consolidated subsidiaries	\$25
	TOTAL SECURED	\$1,167
	Unsecured Creditors/Notes/Claims	
	Debts Subject to Compromise (Based on movement of case)	
	Accounts payable	\$321
	Debt	\$592
	Pension and other postretirement obligations	\$1,773
	Other	\$145
	Accrued income and other taxes	\$45
	Pension and other postretirement	\$1,446
	Bonds	\$1,400
	Other	\$867
	TOTAL UNSECURED	\$6,589
TOTAL		\$7,756

*SEC 10-Q Quarterly Report Filed April 27, 2012

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